

# Mahathir, Soros and the currency markets

**Amoral maybe, but currency speculators are both necessary and productive**

**S**PECULATORS have never had a good press. Almost 30 years ago, British politicians found it convenient to blame the "gnomes of Zurich" for a big devaluation of sterling. Nowadays London itself has become the world's biggest foreign-exchange market, and the complaints have moved eastward. This week an astonishing war of words between Mahathir Mohamad, the prime minister of Malaysia, and George Soros, by now the world's best-known financial speculator, reached a new intensity. Mr Mahathir told the annual meetings of the IMF and World Bank in Hong Kong that currency trading (beyond, he conceded, the level needed to finance trade) was "unnecessary, unproductive and immoral".

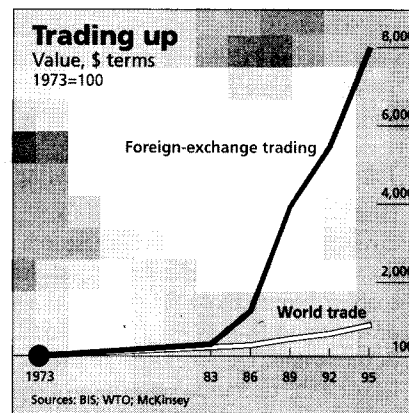
Is it? What is beyond doubt is that, since Britain's spot of bother in the 1960s, the volume of currency trading has burgeoned relative to trade. In 1995 \$1.2 trillion of foreign exchange swapped hands on a typical day. That is roughly 50 times the value of world trade in goods and services. In the early 1970s, prior to the liberalisation of the world's capital markets, the value of currency trading was only six times greater than the value of "real" trade. Mr Mahathir claims that these speculative flows are not only "unproductive", but wreak unnecessary damage on workers and firms.

The Mahathir view of the world rests on a belief that speculators' decisions are guided by their own appetite for profit, and therefore pay little or no attention to the underlying health of economies. But speculators do not select their targets at random. It is true that their objective is to make money, but the best way to do this in the long term is to spot currencies that are out of line with economic fundamentals, and whose price is therefore likely to change. The devaluations of sterling and the lira in 1992, the Mexican peso in 1994 and South-East Asian currencies this year all reflected economic imbalances. The changes in the prices of these currencies were necessary anyway; the speculators, arguably, just called the change first.

Hedge funds, such as Mr Soros's Quantum Fund, have been blamed for much financial turmoil in recent years. The IMF estimates that hedge funds can mobilise between \$600 billion and \$1 trillion to use to bet against currencies and other assets—for example, selling a currency forward in the hope that they can

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buy it back later at a cheaper rate. However, these funds invest a lot of time studying economic and political fundamentals, seeking out those economic imbalances which offer profitable opportunities—such as a fixed exchange rate that conflicts with domestic economic policy. If exchange rates are forced to move in line with fundamentals sooner rather than later, that is probably a good thing for the "real" economies concerned. It is also worth noting that speculators do not attack currencies that are backed by credible economic policies.



Currency trading also plays an important role in providing liquidity in the market for foreign-exchange, helping to match buyers and sellers. Suppose that speculation were banned, so anyone who had bought a foreign-currency denominated asset would have to keep it for a specified period, regardless of changes in economic conditions. In such a situation, there would be a strong incentive not to hold the currency at all. Investors in South-East Asia have, in part, been lured in by the knowledge that they can if necessary get out again quickly.

This suggests that Mr Mahathir is wrong to claim that currency trading has no economic value. But it does not mean currency markets are perfect. Financial markets are vulnerable to "bubbles" and excess volatility. In such cases, prices move more than is warranted by the underlying factors they are supposed to reflect. Differences in countries' inflation rates and current-account deficits explain exchange-rate movements quite well in the long run, but in the shorter run cur-

rencies seem to disregard fundamentals. A case in point is the dollar's rollercoaster ride. Its fall from ¥260 in 1985 to ¥80 in 1995, and its subsequent rebound to around ¥120, cannot really be explained by the fundamentals.

The problem is that all financial markets, from currencies to shares, are subject to waves of excessive optimism followed by excessive pessimism. In theory, speculation should be stabilising: to make money, investors need to buy when the price is low and sell when it is high. However, in a bubble it is profitable to buy even when the price of an asset is high, as long as it is expected to rise further—until the bubble bursts. An investor will lose money if he does not go with the crowd.

### The lesser of two evils

For Mr Mahathir to win his argument, it is not enough to show that financial markets are fallible (a point Mr Soros has famously conceded). He must also suggest a better alternative.

On the face of it, there is a stronger case for governments to interfere in currency markets than in some other markets. A fall of 20% in the price of a particular share will have limited economic repercussions. But a sudden drop of 20% in the price of a currency may provoke foreign countries to block imports, or make companies over-invest when a currency is too cheap.

Several respected economists have pondered the value of measures to dampen currency trading. One such idea is a tax on foreign-exchange transactions, to "throw sand in the wheels of international finance". The snag is that today's technology and financial wizardry would probably make it impossible to enforce such a tax. Moreover, if it substantially reduced liquidity—and hence the ability of investors to sell quickly when the time comes—it might discourage long-term cross-border investment as well as short-term speculation.

In any case, Mr Mahathir and others who favour exerting more control over currency trading are making the dangerous assumption that governments know better than markets what the "correct" exchange rate is. In fact there are good reasons to expect governments to make even bigger mistakes. Moreover, financial markets find it a lot easier than governments to admit their mistakes, and to reverse out of them. That is because one of the unsung beauties of markets is that, unlike governments, they have no pride.